

ANALYSIS OF AMENDED BILL

Author: Lowenthal Analyst: Nicole Kwon Bill Number: SB 686
 Related Bills: See Legislative History Telephone: 845-7800 Amended Date: August 24, 2006
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Economic Incentive Areas

SUMMARY

This bill would make various changes and reforms to existing law regarding Enterprise Zones, Manufacturing Enhancement Areas, Targeted Tax Areas, and Local Agency Military Base Recovery Areas.

This analysis addresses only those provisions of the bill affecting the Franchise Tax Board (FTB).

SUMMARY OF AMENDMENTS

The August 24, 2006, amendments struck the previous provisions relating to Wild Animals and would make revisions to the law applicable to the following Economic Development Areas (EDAs):

- A. Designation of Enterprise Zones.
- B. Designation of Targeted Employment Areas.
- C. Designation of G-TEDAs.
- D. Tax Incentives

Each item is discussed separately below.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to enact meaningful reforms to the EDA programs to ensure that the state maximizes its investment in the programs and targets benefits to economically challenged areas and individuals.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill is effective and operative immediately upon enactment.

Board Position:

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Department Director

Date

Lynette Iwafuchi
for Selvi Stanislaus

9/6/06

POSITION

Pending.

A. Designation of Enterprise Zones

ANALYSIS

STATE LAW

Under the Government Code, state law provides for several types of EDAs: Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), and Local Agency Military Base Recovery Areas (LAMBRAs).

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an EZ. Using specified criteria, the Department of Housing and Community Development (DHCD) designates EZs from the applications received from the governing bodies. EZs are designated for 15 years.

Currently, all of the 42 authorized EZs have been designated.

THIS BILL

This bill would do the following:

- Allow changes to the definition of an EZ's "eligible area" by allowing for noncontiguous boundaries.
- Define "geographically targeted economic development area (G-TEDA)" to mean areas designated as EZs, MEAs, TTAs, and LAMBRAs.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation consideration.

The term "G-TEDA coordinator" is undefined in this bill. It is assumed that "G-TEDA coordinator" is the person who administers all the rules and regulations of G-TEDA. If this assumption is inconsistent with the author's intent, the author's office may want to define this term or specify by cross reference the section of the law if it is already defined.

LEGISLATIVE HISTORY

AB 1550 (Arambula/Karnette, 2005/2006) is identical to this bill. AB 1550 is at the Senate Floor.

AB 485 (Arambula, 2005/2006) is identical to this bill except AB 485 limits the tax incentives during the redesignation period to the hiring credits only. AB 485 is currently in Senate Appropriation Committee.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This portion of the bill is not anticipated to impact significantly the amount of revenue.

Revenue Discussion

This bill would allow changes to the definition of an EZ's "eligible area" by allowing for noncontiguous boundaries. This estimate assumes that, on average, changes in the shape of EZs will not affect the amount of credit claimed in each EZ. Depending on the specific changes made to EZ boundaries, this bill could result in additional changes to the revenue impact of EZs.

B. Designation of Targeted Employment Areas (TEAs)

STATE LAW

Under the Government Code, a TEA is designed to encourage businesses in an EZ to hire eligible residents of certain geographic areas within a city, county, or city and county. A TEA may be, but is not required to be, the same as all or part of an EZ. EZs may draw TEAs to contain census tracts where 51% or more of the individuals are low or moderate income. TEAs are drawn using census data at the time of the EZ's formation. A resident of a TEA can be certified as a qualified employee for purposes of the EZ hiring credit. See discussion below.

BACKGROUND

Currently, census tracts are used to determine TEAs. Census tracts usually contain between 2,500 and 8,000 people, whereas census block groups, the smallest unit of analysis where the Census Bureau measures household income, are statistical subdivisions of census tracts, including between 600 and 3,000 people.

THIS BILL

This bill requires all EZs to redraw TEAs within 180 days of new census data becoming available.

This bill would require a TEA boundary approved prior to the 2000 United States census data to revise to the most recent census data. The bill would exempt from this requirement any EZs that will expire on or prior to December 31, 2008.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations.

The author's office may want to clarify whether TEAs will continue to apply only to EZs or to all G-TEDA. If the author's intention is to allow TEAs to apply to all G-TEDA, a definition for TEA should be added under Government Code section 7072.

On page 5, lines 27 to 29, this bill contains exclusion language that exempts existing EZs that expire on or prior to December 31, 2008. This language could give the meaning that any existing EZ is forever grandfathered from this new requirement even though following a renewal, the former EZ will again expire after December 31, 2008. The author may wish to clarify that the exemption only applies to EZs expiring on or prior to December 31, 2008, and in the case of a renewal and subsequent expiration, the grandfather clause does not apply to the subsequent expiration.

FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This portion of the bill is not anticipated to impact significantly the amount of revenue.

C. Designation of G-TEDA

STATE LAW

Currently the Government Code allows an area to qualify as an EZ in two ways. First, by meeting one of the following criteria: qualifying for the Urban Development Action Grants (now defunct), the area within the proposed EZ has experienced plant closures within the past two years affecting more than 100 workers, meets criterion of economic distress under the Urban Development Action Grants (now defunct), or the area has a history of gang activity. Second, by meeting at least two of the following three criteria: (1) the census tract within the proposed zone have an unemployment rate not less than 3 percentage points above the statewide average for the most recent calendar year as determined by the Employment Development Department (EDD), (2) the county of the proposed zone has more than 70% of the children enrolled in public school participating in the federal free lunch program, or (3) the median household income for a family of four within the census tracts of the proposed zone does not exceed 80% of the statewide median income for the most recently available calendar year.

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an EZ. Using specified criteria, DHCD designates EZs from the applications received from the governing bodies. Once designated, DHCD may audit EZ programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the EZ, provided the business otherwise is still eligible for those incentives.

THIS BILL

This bill would require G-TEDAs designated prior to January 1, 2007, to update their goals and objectives as specified by April 15, 2008. For a G-TEDA that fails to obtain approved goals and objectives by April 15, 2008, would be dedesignated effective July 1, 2008.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

FISCAL IMPACT

This provision of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision of the bill is not anticipated to significantly impact revenue.

D. Tax Incentives

STATE LAW

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within EDAs. These incentives include a hiring credit, sales or use tax credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within EDAs and a tax credit for employees working in an EZ.

Hiring Credit: A business located in an EDA is eligible for a hiring credit equal to a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an EDA and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the EDA and at least 50% of the employee's services must be performed inside the EDA.

The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach EZ, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit. Certain criteria regarding whom may be a qualified employee and certain limitations differ between the various EDAs.

Taxpayers operating in an EDA are allowed the hiring credit for employing "qualified employees." "Qualified employees" for EDAs are defined by reference to various state and federal public assistance programs. The categories of individuals considered qualified employees for the various EDAs are substantially similar but not identical. A taxpayer located in an EDA is allowed a credit of up to 50% of wages paid to "qualified employees." The taxpayer is required to obtain a voucher certificate for each of its "qualified employees." The voucher certificates are issued by the EDD or the local (within the same EDA as the workplace of the employee) agency familiar with the public assistance statutes.

Sales or Use Tax Credit: The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an EDA (except a MEA).

Net Interest Deduction: A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an EZ. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the EZ, and the lender may not have equity or other ownership interest in the EZ trade or business. This incentive is not available for LAMBRAs, the TTA, or MEAs.

Business Expense Deduction: A business located in an EDA (except an MEA) may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the EDA. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. For LAMBRA businesses, the amount of the deduction is added back to the taxpayer's income if at the close of the second year the taxpayer does not have a net increase of one or more jobs (defined as 2,000 paid hours per employee per year). The property's basis must be reduced by the amount of the deduction. For EZs, LAMBRAs, and the TTA, the maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

The applicable
amount is:

Taxable year of designation	\$ 100,000
1st taxable year thereafter	100,000
2nd taxable year thereafter	75,000
3rd taxable year thereafter	75,000
Each taxable year thereafter	50,000

Net Operating Losses (NOLs): A business located in an EDA may elect to carry over 100% of the EDA net operating losses (NOLs) to deduct from EDA income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the EDA.

In the case of corporations doing business both within and outside of this state, California, as do most states, taxes corporations exclusively on a source basis, with source income being determined by use of an apportionment formula for business income and an allocation methodology for nonbusiness income. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned business income (or loss) and its allocated nonbusiness income (or loss).

THIS BILL

This bill would allow DHCD to backdate the effective date of the new zone to the date of the previous zone's expiration in order to cover the gap period between expiration and designation and thereby continue to allow the zone to offer the tax incentives during the redesignation period.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation consideration.

On page 15, lines 31 to 39, this bill contains language that requires a taxpayer to be "doing business within the geographic boundaries" to be eligible to receive tax incentives. It is assumed that this means the expiring zone that has received a conditional designation letter will continue to receive the tax benefits during the gap period for those taxpayers already operating and receiving the tax incentives. If the author's intent is to allow the conditionally redesignated zone to be able to continue to attract new investments during the gap period from taxpayers not already operating in the zone, then the author's office may want to amend the language to include this provision.

TECHNICAL CONSIDERATIONS

On page 19, line 39, the word "or income" should be eliminated.

LEGISLATIVE HISTORY

AB 1550 (Arambula/Karnette, 2005/2006) is identical to this bill. AB 1550 is at the Senate Floor.

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FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the Personal Income Tax and Corporation Tax revenue impact from this bill would be as follows:

Estimated Revenue Impact of SB 686 Effective On Or After January 1, 2007 Enactment Assumed After June 30, 2006 (\$ in Millions)			
	2006-07	2007-08	2008-09
Targeted areas	-\$6	-\$7	--

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

Twenty-three zones are scheduled to expire October 2006, through May 2007. For taxable year 2004, these zones claimed \$140 million in EZ credits.

Under current law, it is assumed that the 23 zones scheduled to expire in 2006 and 2007 would be re-designated as EZs, on average, three months after the zone expiration date. It is estimated that after the zone is re-designated, the credit amounts used would be equal to the credit amounts reported during the year the zone expired, grown by the Department of Finance profit projections.

Under current law, taxpayers would not be allowed to generate credits for sales taxes paid or for wages paid to employees hired during the period between zone expiration and zone re-designation. This estimate assumes that under current law, three months of sales tax credits and three months of first-year wage credits would be lost. Under the provisions of this bill, taxpayers would be allowed to generate credits during this gap period. This estimate assumes that, under this bill, taxpayers would generate the same credits that they would have generated if the EZs never expired. The revenue loss results from the difference between the credits that would be lost under current law during the gap period and the credits that, under this bill, would be allowed to be generated during the gap period. Finally, it was assumed that, under current law, there would be some increase, relative to a year in which the zone designations did not expire, in carryover credit usage due to the loss in generated credits. The net increase in credits used for the 2006 and 2007 liability year are then converted to reflect the fiscal years.

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